# Australia GDP Preview – Q2 2016

by NAB Economics

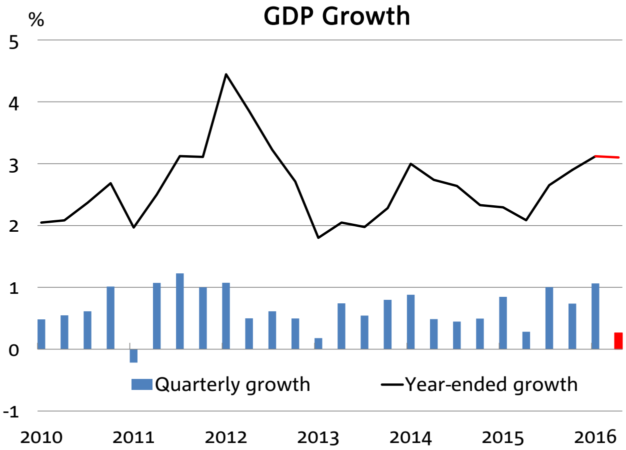
2 September 2016

Q2 GDP data will be released on Wednesday 7 September at 11:30 AEDT. Additional partials will be available next week prior to the GDP release.

- **Q2 GDP growth expected to ease to 0.3% in the quarter (down from 1.1%)**, based on economic partials, largely due to a smaller contribution from net exports. Year-ended growth is expected to be steady at a solid 3.1% y/y – above our estimate of Australia's potential (2.5%[1]) in large part due to base effects from prior large net export contributions (reflecting increased commodity production/exports)
- **The contraction from mining investment has continued as more major mining projects approach completion**, although the offset from stronger export volumes was smaller this quarter. New dwelling construction was positive, albeit surprisingly soft, but renovation activity is expect to provide support. A solid labour market and demand for services is expected to keep household consumption growth solid – but will likely require another fall in the household savings rate given subdued income growth.
- **Evidence of an ongoing recovery in the non-mining economy is expected in the industry gross value added figures, although the pace of recovery may have slowed.** The NAB Business Survey suggests demand for household services (including health), and business services remains solid. However, lower than expected construction of new dwellings may suggest less of an offset to weak non-residential investment for the construction industry, while retail activity looks to have lost more momentum. By state, domestic final demand is expected to have outperformed in NSW and Victoria, while WA will continue to feel pressure.
- **The terms of trade are expected to rise 2.4%,** which is the first increase in more than 2 years and will assist measures of national income – although it is still down 5.6% over the year.
- GDP growth will be more subdued, but a fall in hours worked (consistent with the rise in part-time employment) **suggests an improvement in productivity in Q2.** Beyond the near-term, however, productivity growth is expected to remain muted.
- **Our forecasts are broadly consistent with those in the RBA's latest Statement on Monetary Policy, so are unlikely to have a material impact on the Bank's views.** However, the RBA will be monitoring indicators of the inflation outlook, including average labour earnings and unit labour costs – the former is expected to grow modestly in Q2, while unit labour costs may decline again owing to better productivity.

[1] For NAB's latest estimates of Australia's potential growth rate, please see: [Australia's Changing Growth Potential – 26 May 2016]

**Year-ended GDP growth steady in Q2**




## Domestic demand improving despite mining headwinds

**Australian National Accounts (a)**

| | Q/Q | | Y/Y | Contribution to Q/Q |
|---|---|---|---|---|
| | Mar-16 | Jun-16 | Jun-16 | Jun-16 |
| Household Consumption | 0.7 | 0.6 | 3.0 | 0.3 |
| Dwelling Investment | 1.4 | 0.7 | 6.7 | 0.3 |
| Underlying Business Investment | -4.3 | -2.9 | -15.1 | -0.3 |
| Underlying Public Final Demand | 0.4 | 1.0 | 1.8 | 0.2 |
| **Domestic Final Demand** | **0.1** | **0.3** | **0.6** | **0.3** |
| Stocks (a) | 0.0 | 0.0 | 0.0 | 0.0 |
| **GNE** | **0.2** | **0.3** | **0.6** | **n.a.** |
| **Net exports (a)** | **1.1** | **-0.1** | **2.6** | **-0.1** |
| Exports | 4.4 | 1.1 | 11.6 | 0.2 |
| Imports | -0.8 | 1.6 | -0.5 | -0.3 |
| **GDP** | **1.1** | **0.3** | **3.1** | **n.a.** |

(a) Contribution to GDP growth

Source: NAB Economics, ABS

Our detailed forecasts for the expenditure measure of GDP are outlined in the table above.

**Household consumption:** Private consumption growth is expected to remain solid in Q2, supported by ongoing employment growth and wealth effects from higher property prices. That said, wage growth has remained disappointingly soft, largely dragged down by mining, despite signs of a modest improvement in average weekly earnings in the first half of the year. There is also some concern over the fact that part-time employment has been the primary driver of jobs growth over the past year, which may be contributing to subdued growth in aggregate wages. Real retail sales growth eased a little from last quarter, but services consumption may have again held up better. Indeed, the NAB Business Survey shows trading conditions in personal services remaining elevated in Q2, while the Australian PSI has also stayed in expansionary territory. Overall, private consumption is expected to increase by 0.6% in Q2 (similar to Q1 2016), contributing 0.3 ppts to GDP and raising annual growth to 3%.

**Dwelling investment:** The preliminary construction work done release from the ABS suggests that private dwelling investment may have been more subdued, although there was a solid rise in alterations & additions in Q2 (which are relatively underrepresented in the preliminary CWD data). Preliminary ABS numbers point to growth of 0.7% in the quarter, down from 1.4% growth Q1 – driven by solid growth in alterations & additions, while growth in new dwelling construction was just 0.1%. The subdued rate of growth in new dwelling construction may reflect the lumpy nature of medium-density projects which account for the bulk of the (record high) residential pipeline. It could also suggest emerging bottlenecks, or growing reluctance to proceed with new projects (as housing market fundamentals deteriorate). Assuming most of the pipeline progresses to completion, dwelling construction should still support growth for a number of quarters to come.

**Business investment:** Private business investment is still seeing **a** heavy drag from the mining sector, driving another fall in the quarter. Underlying private business investment is expected to decline by 2.9% in Q2, reflecting the 16% drop in mining investment reported in the ABS Private Capital Expenditure (Capex) Survey. Consistent with this, last Wednesday's construction work done release showed engineering construction contracting by 14.3% in the quarter. In contrast, non-mining investment saw signs of improvement. 'Other selected industries' had a modest increase in investment in Q2, while manufacturing investment actually bounced back from a sharp decline in the previous quarter. Private non-residential building appears to have fallen by a modest 0.5%, while machinery and equipment investment rose 1.7%.

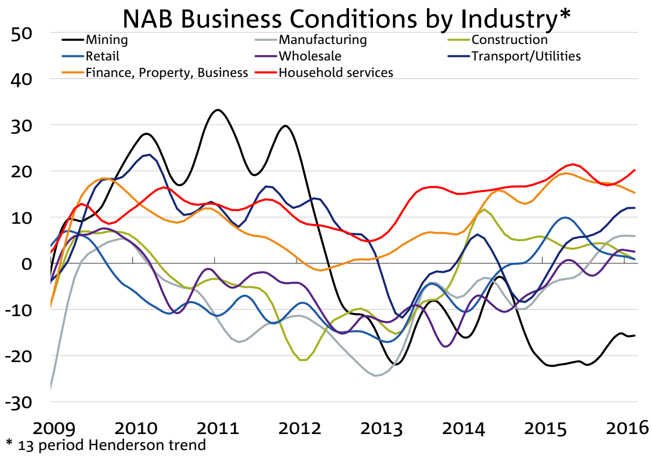
**Government spending:** Preliminary data suggests a pick-up in public investment during Q2, with public construction rising more than 5% in the quarter – a possible reflection of large ongoing infrastructure spending. Growth in government consumption (largely the public sector wage bill) is likely to have been moderately positive given evidence of only subdued growth in public sector wages and a slight decline in hours worked in the sector in Q2.

**Net exports:** Net exports are expected to make a modest subtraction from GDP in Q2, as Q1 was bolstered by a recovery from prior supply disruptions. Nonetheless, trade data showed that the trade balance improved from a deficit of $A8.657bn in Q1 to $A7.983bn in Q2, although this was assisted by a likely modest gain in the terms of trade. Among the bulk export commodities, LNG export volumes lost ground early in the quarter, but recovered sharply in June. Iron ore and coal export volumes have also been mixed, with Port Hedland ore shipments recording a new record in June. Services exports (including tourism and education exports) were up, rising 1.1% in nominal terms in Q2. Import volumes are expected to be modestly positive, suggesting some improvement in domestic demand. Overall, net exports are expected to have subtracted 0.1 ppts from GDP growth in the June quarter.

**Non-mining economy continues to grow**

While we don't explicitly forecast economic output on an industry basis, partial indicators from both employment data and the NAB Business Survey provide a read on potential changes in activity across industries. Outcomes for Q2 2016 were somewhat positive as non-mining employment increased, having been flat in Q1. The Business Survey also shows non-mining sectors (especially services) remaining quite strong, although conditions have eased slightly.

**Service industries remain the best performers**




Source: NAB Economics

## Implications for the RBA's cash rate

For the quarter, the RBA's August Statement on Monetary Policy (SoMP) forecasts year-ended GDP growth of around 3¼%, and would imply quarterly GDP growth of around 0.4% which is only a fraction above our estimate.

The RBA is expecting a smaller contribution to growth this quarter from net exports, and is similarly anticipating further large declines in mining investment. Consequently, the GDP result anticipated by NAB is unlikely to alter the RBA's view of activity in the economy. The Bank is likely to take comfort in improved domestic demand and a further lift in non-mining sectors.

The RBA has already expressed reasonable comfort in the state of economic activity, but is likely to remain focused on National Account measures of prices and wages to confirm the subdued outcome for Q2 CPI.

NAB expects the RBA to remain on hold for the remainder of 2016, but cut twice more in the middle of 2017 with the cash rate reaching a record low of 1%. This expectation reflects NAB's forecast that slower apartment construction in 2018, would otherwise begin to see the unemployment rate begin to rise once more. If inflation were to remain persistently weak thereafter and if the economic outlook were to deteriorate, it is possible the RBA could also consider non-conventional monetary policy measures, though this remains some way off.

## Market implications

*Rates*

The rates market can certainly move on the GDP print but given current pricing and sentiment it will likely have to be significantly different to consensus to get a sustained reaction. At the time of writing (ie pre US payrolls) the market is pricing 27bps of rate cuts for the year ahead and a 40% chance of easing in November. Given current information, expectations of RBA easing are seen to be well priced and so the market is more vulnerable to a spike higher in yields on a stronger than expected print than a move lower on a weaker print.

*Currency*

The RBA will have handed down its latest Cash Rate decision the day before, so with FX markets now increasingly fixated on the FOMC's September meeting, potential for a big move in the AUD on a GDP surprise in either direction appears limited. That said, we'd see more upside potential on a stronger than expected result than downside on a worse than expected outcome, given the prevailing state of money market expectations with respect to RBA policy.

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